COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

USGEN NEW ENGLAND, INC.	)	
NEW ENGLAND POWER COMPANY	)	Docket No. D.T.E. 97-94
MASSACHUSETTS ELECTRIC COMPANY	)	
NANTUCKET ELECTRIC COMPANY	)	

REBUTTAL TESTIMONY

OF

MICHAEL E. JESANIS

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INTRODUCTION

Q. Please state your name and business address.

A. Michael E. Jesanis, 25 Research Drive, Westborough, Massachusetts.

Q. By whom are you employed and what is your position?

A. I am Vice President and Treasurer of New England Electric System ("NEES"). I am also Treasurer of New England Power Company ("NEP"), Massachusetts Electric Company ("Mass. Electric"), and New England Power Service Company ("NEPSCO").

Q. Have you testified before in this proceeding?

A. Yes, my direct testimony was included in the October 1 filing in this proceeding.

PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. My testimony responds to the testimony by Richard Levitan on behalf of Enron Capital and Trade Resources ("Enron"). I begin by introducing the other witnesses in this proceeding, and then explain that Mr. Levitan's analysis is based on a fundamental misunderstanding of the auction process and divestiture. Contrary to Mr. Levitan's suggestion, the divestiture cannot be evaluated on a piecemeal basis, but rather must be seen as a single overall package. As I will explain, the bidding process was carefully structured to define obligations early and to let the bidders value NEP's generation business as a whole. Contrary to Mr. Levitan's conclusion, this process encouraged bidders to maximize the values reflected in their mitigation assumptions and assume the risk of market price fluctuations in the future. Because this value is incorporated in the residual value credit to customers, the auction process has provided the mitigation of total contract termination charges that the Department sought by approving the settlement and that the legislature requires in the recent restructuring act.

In addition, I correct many of the factual misstatements by Mr. Levitan on the Manchester Street project (which Enron has already litigated and lost), on the treatment of gains from the sale of NERC stock (which are being flowed through to customers under the settlement), on the return of the residual value credit to customers pursuant to the settlement which is entirely consistent with the statute that anticipates a reasonable pattern of fixed cost recovery and expressly authorizes a return on equity adjustment that operates like the mitigation incentive in the settlement.

Finally, I address Enron's prior commitments associated with its participation in the divestiture and in the settlement of prior litigation. Enron's position in this proceeding is inconsistent with its agreements, and it is seeking to achieve in this case a result that it was unwilling to pay for in the open market. Enron had a full and fair opportunity to buy the assets that it now contends are underpriced. It declined to do so. Its attempt to disrupt the implementation of the contract by the winning bidder and to disrupt and delay savings to customers should not be countenanced by the Department.

Q. Would you please introduce the other witnesses that will respond to Mr. Levitan?

A. Yes. Mr. Paul F. Levy, Adjunct Professor of Environmental Policy at the Massachusetts Institute of Technology, addresses the methodology used in the auction process and its success in mitigating NEP's contract termination charges. Mr. Levy filed initial testimony in this case and followed the auction process as it was implemented by the Company. As he explains, the allocation of obligations in the bidding process was intentionally designed to bring competitive forces to bear on the issue of market price risks and mitigation opportunities, and to capitalize the most optimistic projections of market prices and mitigation opportunities in the purchase price for the assets. As he explains, the result is reasonable and in the public interest, and should be approved by the Department. In addition, Mr. Levy addresses Mr. Levitan's concerns that the wholesale standard offer price is too low. Mr. Levy explains that it is unclear if the standard offer price depressed the sale price of the assets, but even if it did, the reduction is justified on public policy grounds and is consistent with the Department's approval of the settlement in Docket D.P.U. 96-25.

Mr. Michael E. Hachey, Vice President and Director of Generation Marketing for NEP, discusses NEP's purchased power contracts including the mitigation efforts that NEP has previously implemented to reduce these costs. As Mr. Hachey explains, Mr. Levitan's allegations that NEP has not reasonably mitigated and managed its purchased power costs are unfounded. Mr. Hachey is also available to respond to questions about the Manchester Street litigation with Enron. He was a witness in the prudence proceeding at FERC, and a negotiator of the settlement in which Enron withdrew its litigation in the court proceedings.

Finally, Dr. Joe D. Pace, economist and managing director of LECG, Inc. addresses Mr. Levitan's contentions on market power. Dr. Pace has performed the market power analysis for the transaction in connection with NEP's § 203 application at FERC. As he explains, the NEP sale to USGenNE does not create market power under the Department of Justice and FERC guidelines. Moreover, he corrects several mistakes in Mr. Levitan's analysis and demonstrates that the transaction will reduce market concentration. Dr. Pace's conclusion is supported by common sense. USGenNE is buying less than all of NEP's generation and immediately reselling the entitlements in the Ocean State Power projects to TransCanada subsidiaries. The concentration of generation ownership is declining. Vertical integration of NEP's generation facilities from the transmission and distribution business is being eliminated. The transaction is procompetitive. Dr. Pace documents in detail this straightforward finding.

I. Mr. Levitan Misunderstands the Design of the Auction Process and its Results

Q. Would you please summarize Mr. Levitan's primary recommendations concerning the divestiture transaction?

A. Yes. Mr. Levitan argues that NEP has not fully mitigated its purchased power expense, and that by agreeing to a fixed copayment, NEP is subsidizing the purchaser under the transaction. Thus, Mr. Levitan recommends at pages 24-25 of his testimony that the Department approve the sale of NEP's plants for $1.59 billion "so long as the PPA Transfer Agreement and associated fixed contribution thereunder is excluded from the transaction." Mr. Levitan also argues that the requirement for the purchaser to provide standard offer service at defined prices reduced the purchase price and the residual value credit. (Levitan Testimony, p. 26). Thus, he recommends that the backstop standard offer obligation be removed (see page 36).

Both of these recommendations would undermine the key benefits of the transaction for customers. Contrary to Mr. Levitan's recommendations (1) NEP cannot separate the purchase of generating assets from the assumption of IPP contracts because they were bid and sold as a package, (2) the copayment recognizes that the buyer rather than NEP will have the resources and ability to mitigate IPP contracts and thus allocates risk most efficiently, and (3) the copayment obligation is designed as a security device and is not necessarily intended to represent the exact above market value of the contracts.

Q. How do Mr. Levitan's recommendations undermine the benefits to customers?

A. Part of a successful sale process involves allocation of risks between buyer and seller to the party best able to manage those risks. With the exception of its residual nuclear entitlements, NEP is completely exiting the generation and wholesale power marketing businesses. As a result, NEP will neither have the personnel, nor the portfolio of assets to manage the risks and opportunities associated with the IPP contracts or the standard offer backstop. On the other hand, USGenNE and the other bidders have the financial, human and physical resources, together with the daily interaction with the market to maximize the value and minimize the risks associated with these obligations. USGenNE, rather than NEP, will have the best capabilities to renegotiate contracts with power suppliers and to manage the market price risks associated with these obligations.

Q. Did NEP test the market to determine whether its hypothesis was accurate?

A. With respect to the standard offer backstop, NEP did not test the market. When NEP entered into the Consumers' First settlement, it had no intention of retaining the standard offer backstop obligation given its commitment to divest the assets which make such a backstop possible. With respect to the IPP contracts, NEP did test the market in the first round bidding. Specifically, in my original testimony, I described the six business units which NEP established for first round bidding, one of which was made up exclusively of power contract obligations. NEP allowed bidders to make bids for any business unit, or combination of business units. As a result, bidders had the option to include or exclude the power contracts business unit, or provide bids on both options. Furthermore, NEP asked bidders to provide NEP with the terms by which they would accept responsibility for the power contracts.

Q. What did the first round bids tell NEP about the willingness of bidders to assume these obligations?

A. The first round bids provided important market insights. First, most of the best first round bids included a willingness to take over the power contract entitlements. Second, the three best first round bids asked that NEP provide the buyer with a fixed stream of copayments rather than a market-based stream. These three bids formed the basis for NEP's establishment of a fixed copayment stream as a term of second round bidding.

Q. Mr. Levitan complains that the fixed copayment stream represents a subsidy to USGenNE. Is he correct?

A. Absolutely not. USGenNE and the other second round bidders submitted final bids based on the same fixed copayment stream. If any bidder believed that the copayment stream was higher or lower than that necessary to cover the above-market payments to power suppliers, the bidder would likely adjust its proposed purchase price accordingly.

Q. Mr. Levitan also complains that NEP did not mitigate its contract obligations by including them in the sale to USGenNE. Is his complaint warranted?

A. No. Including the power contracts in the sale likely led to the highest mitigation of power contract obligations for several reasons. First, as I earlier described, the buyer and not NEP possess the human and physical resources to effectively manage these obligations.

Second, NEP believes that in a highly competitive auction process, winning bidders are those willing to make the most aggressive bidding assumptions. These <u>assumptions</u> include the market price of power, the cost of operating the generating plants, and the ability to mitigate the cost of power contract obligations. By including the contracts, NEP's customers benefit from aggressive bidder assumptions, and shift to bidders the risks and reward of achieving those assumptions. Lastly, under the wholesale settlement agreement, NEP has an obligation to attempt to divest its power contract obligations. NEP had two avenues available for meeting its obligation under the settlement: dispose of the contracts as part of the sale, or dispose of them separately. NEP believes that the market is extremely thin for the sale of largely inflexible power contracts. This belief was supported in the overall sale process. While NEP received several solid proposals as part of the plant divestiture process for taking over the contracts, it received only a single unattractive proposal for taking over the power contracts as a separate business unit.

Q. Does the copayment provide any other advantage to NEP and its customers?

A. Yes. It provides security for performance. Although as Mr. Levitan suggests, NEP could have set the copayment at zero, and simply realized lower cash proceeds on the plants in return for the buyer's assumption of the above-market IPP obligations, the copayment provides the central advantage of tying future payments by NEP to future performance by the buyer. It recognizes that unless permanently assigned to the buyer, the contracts represent the potential for a continuing obligation by NEP. Thus, for NEP to realize the full benefit of the sale, the buyer must continue to purchase the power produced under the IPP contracts.

The benefits of the copayment can be illustrated by a simple hypothetical. The present value of the copayment is about $1.2 billion at a 6.25 percent discount rate. (See response to DTE-1-7). Assuming all bidders have the same discount rate (which they do not), NEP could either have set the copayment at zero and received only $400 million for the transaction or structured it as in the final divestiture plan.[1] Absent a release to NEP, the primary economic difference between the two cases occurs if the buyer defaults on its

[1]In fact, this result will be produced if all IPP contracts are reformed or assigned to USGenNE in a fashion that releases NEP from liability, because NEP would make trigger payments in this amount.

obligations to purchase the IPP power. In case 1, NEP would remain obligated to pay the suppliers under the IPP contracts, but would have sold its plants for only $400 million. As a result, NEP's risk for economic loss as the result of a default by the buyer are high. However, under the divestiture as proposed, NEP will have received $1.6 billion in cash, up front, and in the event of a default by the buyer would be able to use the copayments to offset contract payments to IPP suppliers. At the levels established in the IPP transfer agreement, the copayments would maintain much of NEP's underlying economic value of the transaction.

Q. Are there any other features of the IPP transfer agreement that are designed to assure future performance by the buyer?

A. Yes. There are two. First, USGenNE can convert the payment stream associated with the copayment into a single up front cash payment in the event of a permanent assignment, buyout, or contract reformation that permanently releases NEP from its obligations under the IPP contracts. These trigger payments represent the future value of the copayment stream. They also provide financial resources to the buyer in the event that the most efficient way for the buyer to reform the contracts is to buy them out.

The second feature of the IPP Transfer Agreement that is designed to assure performance by USGenNE is the corporate guaranty by PG&E Corporation the corporate parent of USGenNE (Contract Book 1, p. 471). This guaranty applies to payments to IPP's and remains in effect until after the closing, and after the USGenNE reaches a minimum level of net worth and attains an investment grade bond rating (Contract Book 1, p. 472). Together with the copayment discussed above and the cash purchase price payable on closing, the divestiture transaction is designed to assure that NEP and its customers actually receive the full value produced by the auction process. In addition, the structure of the transaction provides assurance to IPP suppliers that their contracts will be honored by the buyer. Mr. Levitan's recommendation undercuts that security. It is inconsistent with sale process and rules. His suggestion to separate IPP contracts from the asset sale should be rejected by the Department.

Q. Does the same analysis apply to Mr. Levitan's recommendation on the standard offer?

A. Yes. Again the standard offer is part of the deal that was included in the ground rules to all bidders. It cannot be separated from the transaction at this date, even if NEP wished to, which it does not. Changing obligations and value after the bid is complete is neither fair to the winner, USGenNE, nor to the other bidders for whom the standard offer was a key element in the valuation.

Moreover, as with the IPPs, there are an array of uncertainties associated with the standard offer. Bidders needed to estimate the results of the wholesale standard offer auction, the number of retail customers served under the standard offer, the decay rate, the market price for substitute sales, and the rate of development of the market. The auction process was designed to let the market value these imponderables, rather than living by NEP's assumptions. Opinions about the relative value of the standard offer have been sharply mixed in administrative proceedings. The Town of Norwood, represented by Rubin and Rudman, has argued in court and FERC proceedings that the standard offer is too high. Here, Enron, also represented by Rubin and Rudman, is arguing that the price is so low as to depress the residual value. There is no clear answer to the question.

However, the auction process fairly valued the uncertainties and the standard offer rights and obligations. These rights and obligations were agreed upon in the settlement, approved over Enron's objection by the Department, and form the basis for the rate path that is reflected in the Massachusetts Restructuring Law. The auction process fairly valued the rights and obligations. Mr. Levitan's recommendation that the standard offer obligation be eliminated from the contract for sale should be rejected by the Department.

Q. What if Mr. Levitan is right and the standard offer obligation has depressed the purchase price and the residual value credit?

A. As Mr. Levy explains in his testimony, it is not clear that the standard offer reduced the price received for NEP's generating assets and that even if the price were reduced, the reduction would be justified on public policy grounds. My point is a little different. Both the standard offer and the residual value credit are for the benefit of customers. If the standard offer depressed the residual value credit, then customers would have received more value through the option created by the standard offer. The value to customers as a group will not have changed. The standard offer and residual value credit are both for the benefit of customers. A shift in the value of one component to the other does not affect the overall level of value conferred.

II. Factual Issues Raised by Mr. Levitan

A. Manchester Street Prudence

Q. Mr. Levitan criticizes the Manchester Street Project at pages 14 through 16 of his testimony. Would you respond?

A. Yes. Enron's claims with regard to the prudence of the Manchester Street Project raised by Enron's affiliate Milford Power Limited Partnership (Milford) were fully litigated before FERC and decided by that agency. A copy of the Administrative Law Judge's decision is attached as Exhibit MEJ-1. This decision was made final by the Commission on May 20, 1996 (See Ex. MEJ-2). The conclusion of the ALJ's opinion is as follows:

> Under the *Anaheim* test, a participant must raise a "serious doubt" about the prudence of an expenditure before the utility "has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent." 669 F.2d at p. 809. Whether the doubts raised in this proceeding by Milford can be elevated to the level of "serious doubt" is itself doubtful for Milford's asseverations have been shown to be premised, in the main, not on

> fact but rather on misinformation, failure to reasonably rely on available information, unsupported assumptions, innuendo and pure speculation.
>
> Assuming, *arguendo*, that Milford's asseverations have raised "serious doubts," NEPCO has sustained its burden under *Anaheim*. As the record compiled in this proceeding makes clear, from 1988, when NEPCO initially began to consider repowering Manchester Street, to July 1992, when construction began, the decision to proceed with repowering Manchester Street was subjected to prudent and reasonable scrutiny and evaluations. NEPCO undertook a thorough and comprehensive economic analysis that included a variety of alternatives, took into account relevant and updated information, and gave appropriate weight to the costs and benefits associated with the various options. Furthermore, several state regulators scrutinized and approved the proposed project and NEPCO complied with their edicts. It is difficult to imagine what else NEPCO would have done to be more reasonable and prudent in its decision-making process. NEPCO is also sustained in its presentation under the Commission's criteria in *New England* in that the costs it incurred with regard to the Manchester Street Project "are costs which a reasonable utility management (or that of another jurisdictional entity) would have made, in good faith, under the same circumstances, and at the relevant point in time." 31 FERC at p. 61,084.

In addition, Milford dropped all of its claims in a related court action and signed the release attached as Exhibit MEJ-3. Mr. Levitan's testimony and conclusions on the

Manchester Street Project are unwarranted, unfounded, and inconsistent with Enron's prior commitments. The Department should rely on FERC's findings as set forth in Ex. MEJ-1).

B. Sale of NERC Stock

Q. Mr. Levitan suggests that NEP is retaining a capital gain from its sale of NERC stock, is he correct?

A. No. Mr. Levitan's suggestion at page 24 of his testimony is incorrect. The NERC stock sale is described in Ms. Kenney's testimony at pages 12-13 (pp. 113-14 of the Volume). Under the transaction, NEES, the current owner of the NERC stock, will transfer the stock to NEP at its book value of about $32 million. As a result, NEES will not realize any gain on the sale. NEP will then have the NERC stock on its books at book value. Ms. Kenney subtracted only this $32 million of book value from the proceeds of the sale when calculating the Residual Value Credit. The remaining proceeds from the transaction, which includes the market value that USGenNE ascribed to the stock, are then flowed through to customers. As a result, the gain on the sale, if any, is fully credited to customers through the residual value credit, and NEP only recovers the book investment in the stock.

C. Return of Residual Value Credit

Q. Mr. Levitan suggests that NEP should return the sale proceeds to customers over a single year rather than the period ended on December 31, 2000 as proposed by Ms. Kenney. Would you comment on this suggestion?

A. Mr. Levitan's suggestion (at pages 6 and 27 of his testimony) that the divestiture proceeds be returned in one year is unclear. In our proposal, NEP is netting the proceeds from the sale against the fixed component of the contract termination charge, and recovering the balance over the period ending December 31, 2000. There is no rationale for returning sale proceeds in one year and recovering the same investment over a longer period. If the return of the residual value credit and recovery of fixed costs are not coordinated, unstable prices can be produced for customers. For example, Mr. Levitan's suggestion could produce a charge of negative four cents per kilowatthour followed by significant increases thereafter. This drastic price drop followed by major increases is inconsistent with the settlement. In the settlement, NEP reserved its rights to “revise the variable cost estimates and the amortization of fixed cost components in Schedule 1 to reflect the assignment of obligations to the purchasers, if such revision is necessary to maintain a stable and declining pattern of Contract Termination Charges as offset by the Residual Value Credit.” (NEP Settlement, p. 55, n. 9). Mr. Levitan’s recommendation does not maintain the required stable and declining pattern of Contract Termination Charges. Under our proposal, the net proceeds from the sale are returned earlier than required in the original settlement and with a full return on the unamortized proceeds. The statute does not require any further modification to the settlement time lines. Mr. Levitan’s recommendation is unworkable and should not be adopted.

D. The Mitigation Incentive

Q. Mr. Levitan also disputes the mitigation incentive. Would you respond?

A. The mitigation incentive in the settlement has been approved by the Department and FERC. It is also consistent with the statute which specifically authorizes an adjustment to the return on equity for a reduction in the contract termination charge. The statutory adjustment is patterned after and is consistent with the mitigation incentive incorporated in the settlement. (See G.L. c. 164, § 1G(b)(3)).

III. Enron's Arguments in this Case are Inconsistent with its Actions

Q. Was Enron a participant in the bidding process for NEP's assets?

A. Enron participated in the early stages of the process. It signed a confidentiality agreement and had substantial access to the data room that included proprietary information about NEP's facilities and business. However, Enron declined to submit a bid. Under the procedures of the auction process, Enron was given a full and fair opportunity to participate, bid, and pay the full market value for the assets that Mr. Levitan contends are underpriced. Enron declined to do so. As a result, its complaints about too low a price ring hollow.

The Department should look to Enron's actions not its arguments. It should recognize that if Enron thought that NEP's assets would be underpriced, it would have participated in the auction and not in this proceeding. The Department should not allow unhappy bidders to disrupt the closing of a reasonable sale of NEP's assets arrived at after a full and fair market valuation. Mr. Levitan's suggestions should not be adopted in this proceeding.

Q. Thank you. I have no further questions.